6.06 L/T Debt, Stockholders' Equity & Payroll

Auditing Long-Term Debt: Overview

Long-term debt consists of **notes payable, bonds payable,** and **lease obligations**. Transactions involving long-term debt tend to be well documented, including authorization from the board of directors or others who are charged with governance, formal agreements between the lender and the entity, and scheduled payments. When payments are made on a timely basis, all amounts, including interest expense, the ending balance of the long-term liability, and the current portion are all readily determinable.

Due to the nature of long-term debt, including the fact that transactions tend to be infrequent, material, and well documented, the auditor will frequently rely heavily on substantive testing.

Objectives

- Adequate I/C
- **R**ights & obligations – Debt is obligation of entity.
- **A**llocation & valuation – Debt is recorded in appropriate amount.
- **C**ompleteness – All debt recorded.
- **E**xistence – Debt actually exists.

Forms of Evidence

There are various forms of evidence the auditor may use in the audit of long-term debt. Some will be obtained from the client, some directly from outside sources, and some may result from the direct actions of the auditor.

- Copies of notes and loans payable and long-term leases
- Spreadsheets and other schedules prepared by the client to recognize principal and interest allocations, determine the current portion of long-term debt, and to keep track of long-term liabilities
- Confirmations from creditors

RACE Approach to Audit Procedures for Long-Term Debt

Rights & Obligations

The entity borrowed the money represented by long-term debt and is obligated on the liability. A misrepresentation might occur, for example, if a liability of a member of management was recorded as a liability of the entity.

Substantive procedures may include:

- Tracing recorded liabilities to supporting documentation **(inspection)**

- Verifying that transactions in which long-term debt was recorded resulted in a deposit of cash for the proceeds **(inspection)**
- Obtaining **confirmation** from creditors

Allocation & Valuation

The amounts reported in long-term debt are accurately measured. A misrepresentation might occur, for example, if the entity incorrectly allocated payments between principal and interest, overstating or understating the principal balance.

Substantive procedures may include:

- Comparing the ending balances reported for long-term debt to the auditor's expectations developed from reviewing loan documents and from repayment schedules **(analytical procedures)**
- Obtaining **confirmation** of ending balances directly from creditors

- **Recalculating** the current portion of long-term debt to verify that the amount reported by the entity is accurate
- **Recalculating** allocations between principal and interest to determine that periodic payments have been properly reported

Completeness

All long-term debt consists of liabilities that are the obligations of the entity and are included in the amounts reported on the B/S. A misrepresentation might occur, for example, if the entity were to record proceeds from a borrowing transaction as revenue or as a capital contribution.

Substantive procedures may include:

- Comparing the relationship between interest expense and the average balance in long-term debt to determine if the relationship is reasonable based on the auditor's knowledge of terms the entity would be subject to **(analytical procedures)**
- Obtaining **confirmations** directly from creditors, including a standard bank confirmation, requesting information about all liabilities owed by the entity to make certain that there are no exclusions
- **Inspecting** the cash receipts journal and tracing significant deposits to source documents to determine if any represent liabilities that have not been recorded as such

Existence

The amount reported as long-term debt represents legitimate obligations that resulted from borrowing transactions that actually occurred.

Substantive procedures may include:

- Obtaining **confirmations** directly from creditors verifying amounts payable and terms of the liabilities
- **Inspecting** long-term leases, notes and loans payable, and other agreements documenting long-term debt arrangements

- Tracing proceeds from borrowing transactions recorded in the cash receipts journal to supporting documents providing evidence of the existence of long-term liabilities **(inspection)**
- **Inspecting** minutes from board of director meetings or meetings of those charged with governance to verify that borrowing transactions have been authorized

Summary of Alternative Approaches for Long-Term Debt*	
RACE	PERCV
***R*ights & obligations** • Trace liabilities to loan documents ***A*llocation & valuation** • Trace liabilities to transaction documents • Trace liabilities to subsequent payment • Confirm amounts with creditors ***C*ompleteness** • Evaluate subsequent disbursements • Confirm amounts with creditors • Review minutes for debt authorizations • Obtain letter from attorney • Analytical procedures ***E*xistence** • Trace to loan documents • Trace subsequent payments	***P*resentation & disclosure** • Review disclosures for GAAP compliance • Inquire about pledging of assets • Review debt agreements for pledging & events causing default ***E*xistence or occurrence** • Confirm terms & balances with creditors • Inspect copies of notes & note agreements • Trace receipt of funds (& payment) to bank account and cash receipts journal ***R*ights & obligations** • Review cutoffs • Review minutes for proper authorization (& completeness) ***C*ompleteness & cutoff** • Analytical procedures • Inquire of management as to completeness • Review bank confirmations for unrecorded debt ***V*aluation, allocation & accuracy** • Foot summary schedules and reconcile to G/L • Vouch entries to account • Recalculate interest expense & accrued interest payable

These lists are not intended to be all-inclusive.

The audit of long-term debt is normally quite limited since, by its nature, long-term debt is likely to involve few transactions during a typical year, except for interest payments. As a result, the verification of interest expense and accrued interest payable are the most common objectives, with analytical procedures comparing interest expense to the related debt being the most useful. Confirmation of long-term debt with payees, trustees and other appropriate third parties, may be used to verify any applicable sinking fund transactions. The auditor may also examine legal agreements in connection with such obligations.

Though there is little likelihood of notes and bonds payable going unrecorded, proper **classification** on the B/S is an important issue in connection with the assertion of **disclosure and**

presentation. In particular, if a current note is renewed shortly after year-end, the auditor needs to ensure that the note is classified as a long-term debt rather than a current one.

Going Concern

Although not required in some special purpose financial reporting frameworks, when F/S are prepared in accordance with GAAP, ASC 205, Subtopic 40, requires management to evaluate whether the entity has the ability to continue as a going concern for a reasonable time. The ability to continue as a going concern implies that the entity will be able to meet its obligations as they come due. A reasonable period of time is considered one year from the date on which the F/S are issued, or, when appropriate, one year from the date on which they are available to be issued.

Even when the AFRF does not require management to perform such an evaluation, if characteristics of the financial reporting framework according to which the F/S are being prepared incorporate a going concern assumption, the preparation of the F/S requires management to assess the entity's ability to continue as a going concern. The framework in use can indicate such an assumption when receivables are written down to amounts expected to be received, payments for assets are capitalized and amortized instead of being expensed when incurred, and other accounts with long-term implications are handled in a similar manner.

Unless F/S are prepared in accordance with the cash basis or a comparable basis, they are likely being prepared in accordance with a going concern assumption. As a result, preparing the F/S requires management to assess the entity's ability to continue as a going concern even when the AFRF does not explicitly require it.

During the performance of the risk assessment procedures applied by the auditor in obtaining an understanding of the entity and its environment, including its internal control, the auditor should determine if management has made a preliminary evaluation of whether events or conditions exist that raise doubts.

- If management has performed such an evaluation, the auditor should discuss it with management and, if management has identified events or conditions that raise substantial doubt, the auditor should understand management's plans to address them.
- If management has not performed such an evaluation, the auditor should inquire of management whether such events or conditions exist.

The auditor's evaluation should address management's evaluation, covering the same period of time, and should consider whether management has evaluated all events and conditions of which the auditor is aware.

When events or conditions have been identified, the auditor is required to obtain sufficient appropriate audit evidence as to whether they, when considered in the aggregate, raise a substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, as well as any mitigating factors. The auditor's procedures will include:

- Requesting management to make an evaluation if one has not already been made .
- Evaluating management's plans in relation to the events and conditions to determine if it is probable that they can be implemented effectively and would mitigate the events and conditions that raise the doubt.
- Evaluating a cash flow forecast and analysis, if one was prepared by management, including the reliability of the underlying data and determining if there is adequate support for assumptions made.

- Considering whether additional facts or information have become available based on which management made its evaluation.

If, before considering management's plans, the auditor believes that substantial doubt exists as to the entity's ability to continue as a going concern, the auditor should request written representations from management. They should:

- Describe management's plans intended to mitigate the adverse effects of events or conditions contributing to the substantial doubt, including the probability that they can be implemented effectively.
- Indicate that all relevant matters of which management is aware have been disclosed, including significant conditions and events, and also including management's plans.

Based on the results of the audit procedures applied, the auditor will conclude that either management's plans do, or do not, alleviate the adverse effects of events and conditions causing the substantial doubt as to the entity's ability to continue as a going concern. Based on that conclusion, the auditor will determine if disclosure is adequate.

- If management's plans are expected to mitigate the adverse effects, indicating that there is no longer substantial doubt as to the entity's ability to continue as a going concern, the disclosure should describe the events and conditions that created the doubt, management's evaluation of their significance, and management's plans that mitigated the adverse effects.
- If management's plans are not expected to mitigate the adverse claims to the extent that they remove the doubt, the disclosure will be similar, except it will also indicate that there is substantial doubt. In addition, it will refer to management's plans that are intended to mitigate the effects, rather than indicate that the effects have been mitigated.

Auditing Stockholders' Equity

Stockholders' equity consists of **common** and **preferred stock**, **additional paid-in capital (APIC), treasury stock, retained earnings,** and **accumulated other comprehensive income (AOCI)**. Transactions involving stockholders' equity are generally limited to issuances or reacquisitions of stock, which are relatively rare; paying **dividends**; and closing net income or loss and other comprehensive income or loss into retained earnings and AOCI, respectively.

- Transactions involving issuance or reacquisition of stock or the payment of dividends tend to be well documented and require authorization by the board of directors or those others who are charged with governance.
- Since the auditor is applying auditing procedures to obtain evidence to support the components of, and amounts reported as, net income and OCI, the auditor will need to determine that the amounts have been appropriately recognized in retained earnings and AOCI.

Due to the nature of stockholders' equity, including the fact that transactions tend to be infrequent, material, and well documented, the auditor will frequently rely heavily on substantive testing.

Objectives

- Adequacy of I/C over stock transactions
- Transactions properly authorized and comply with regulations
- Transactions recorded in conformity with GAAP

- Adequately disclosed in F/S

Forms of Evidence

There are various forms of evidence the auditor may use in the audit of stockholders' equity. Some will be obtained from the client, some directly from outside sources, and some may result from the direct actions of the auditor.

- Copies of minutes of meetings of the board of directors or those charged with governance authorizing the issuance or reacquisition of equity shares or the payment of dividends
- Confirmations from transfer agents or registrars indicating any transactions involving equity shares
- Stock certificate books for entities that do not use transfer agents

RACE Approach to Audit Procedures for Stockholders' Equity

Rights & Obligations

Stockholders' equity represents ownership interests in the entity. A misrepresentation might be the inclusion a hybrid instrument that is more like debt than equity in the stockholders' equity section of the B/S.

Substantive procedures may include:

- **Inspecting** minutes of board of director meetings or meetings of those charged with governance to verify that transactions recognized in stockholders' equity accounts have been authorized
- **Inquiring** of the entity's attorneys to determine if there are any legal issues affecting equity interests
- **Inspecting** the articles of incorporation or other corporate documents to determine if there are restrictions on equity ownership and if all issuances of stock are authorized

Allocation & Valuation

The amounts reported in stockholders' equity are accurately measured. A misrepresentation might occur if the entity incorrectly allocated proceeds from the issuance of stock or amounts paid to reacquire stock between common stock or treasury stock and additional paid-in capital.

Substantive procedures may include:

- Tracing dividend payments to supporting authorizations by those charged with governance and to entries to retained earnings to determine that they have been recognized properly as reductions to retained earnings **(inspection)**
- Tracing the closing of net income into retained earnings and OCI into AOCI **(inspection)**
- **Recalculating** the adjustments that result from treasury stock transactions to verify the accuracy of their recording
- Tracing entries to stockholders' equity accounts to the related cash receipts, for issuances, or disbursements, for reacquisitions, to determine that all have been properly reported **(inspection)**

- Tracing all remaining transactions increasing or decreasing stockholders' equity accounts to supporting documentation to verify that they have been reported accurately (**inspection)**

Completeness

All equity interests in the entity are included in the stockholders' equity amounts reported on the B/S. A misrepresentation might occur if the entity were to record proceeds from the issuance of stock as a borrowing transaction.

Substantive procedures may include:

- **Inspecting** the cash receipts journal and trace significant deposits to source documents to determine if any represent issuances of equity securities that have not been recorded as such
- **Inspecting** minutes of board of director meetings or meetings of those charged with governance to determine if there are any authorizations for the issuance of equity securities that did not result in increases in the amounts reported
- **Inquiring** of management and others as to whether there was an issuance of equity securities during the period
- **Inspecting** the stock certificate book, if applicable, to make certain that all certificates have been accounted for
- Obtaining **confirmations** from transfer agents or registrars, if applicable, to determine if equity securities have been issued during the period but not recorded

Existence

The amount reported as stockholders' equity represents legitimate ownership claims to the entity. A misrepresentation might result from recording money borrowed as proceeds from the issuance of equity or unrecorded reacquisitions of shares.

Substantive procedures may include:

- Obtaining **confirmations** directly from the entity's stock registrar or transfer agent, if applicable
- **Inspecting** the stock certificate book in the custody of the entity if the entity does not use a transfer agent
- Tracing entries made in the stockholders' equity accounts to underlying supporting documents *(***inspection)**

- **Inspecting** minutes from board of director meetings or meetings of those charged with governance to verify that transactions recognized in stockholders' equity accounts have been authorized

Alternative Approaches to Audit Procedures for Stockholders' Equity*	
RACE	**PERCV**
***R**ights & obligations* • Review minutes for proper authorization • Inquire of legal counsel on legal issues • Review Articles of Incorporation and bylaws for propriety of equity securities ***A**llocation & valuation* • Agree amounts to the G/L • Vouch dividend payments • Vouch all entries to retained earnings • Recalculate treasury stock transactions ***C**ompleteness* • Analytical procedures • Inspect treasury stock certificates ***E**xistence* • Confirm with registrar and transfer agent • Inspect stock certificate book (when no registrar or transfer agent) • Vouch capital stock entries	***P**resentation & disclosure* • Review disclosures for GAAP compliance • Review information on stock options, dividend restrictions ***E**xistence or occurrence* • Confirm with registrar and transfer agent • Inspect stock certificate book (when no registrar or transfer agent) • Vouch capital stock entries ***R**ights & obligations* • Review minutes for proper authorization • Inquire of legal counsel on legal issues • Review Articles of Incorporation and bylaws for propriety of equity securities ***C**ompleteness & cutoff* • Analytical procedures • Inspect treasury stock certificates ***V**aluation, allocation & accuracy* • Agree amounts to the G/L • Vouch dividend payments • Vouch all entries to retained earnings • Recalculate treasury stock transactions

**These lists are not intended to be all-inclusive.*

There are generally very few transactions involving the stockholders' equity section, so audit procedures in this area are quite limited. With respect to capital stock and other securities, the auditor will verify that all issuances are approved by the board of directors and consistent with the articles of incorporation. A registrar is normally responsible for executing such transactions, so **confirmation** is an appropriate procedure along with **review of the minutes** of board meetings and inspection of corporate documents.

The primary concern with respect to retained earnings is that any **restrictions** on the use of it for the payment of dividends are disclosed on the face of the statement or in the notes to the F/S.

Dividends

Important Dates

The auditor should be familiar with three important dates related to the declaration and payment of dividends to make certain that they are reported in the appropriate periods.

- **Declaration date** – The date on which the board of directors commits to the dividend, determining the amount of the dividend to be distributed, at which time a liability has been incurred and is recorded.
- **Record date** – The date that is used to determine which shareholders will receive the dividend, which will be those who have legal rights to the shares on that date.
- **Payment date** – The date on which the distribution is made to the shareholders of record.

Types of Dividends

Dividends may be distributed in a variety of different forms:

- **Cash** dividends are the most common.
- **Property** dividends result when the entity distributes assets other than cash to shareholders, at which time a gain or loss is recognized as if the asset were sold for its fair market value, with that amount being reported as a liability.
- **Scrip** dividends are interest-bearing notes given to shareholders to be paid in the future, which are used when an entity wishes to declare a dividend but it does not have the cash to pay it.
- **Liquidating** dividends are distributions of the entity's cash and assets to shareholders during the process of liquidating the company, reported by shareholders as a return of their capital.
- **Stock** dividends involve the entity issuing shares of stock instead of cash.

Stock dividends involve the distribution of additional shares to existing shareholders in lieu of a cash dividend.

- A stock dividend may be considered a *small* stock dividend, usually when the distribution is 20% or less of the outstanding stock. In this case, retained earnings is reduced by the fair value of the shares issued, and the stock is recorded as if issued for that amount.
- A stock dividend may be a *large* stock dividend, usually when the distribution is 25% or more of the outstanding stock. In this case, retained earnings is decreased, and common stock is increased for the par or stated value of shares issued.
- Stock dividends that are for between 20 and 25% of the shares outstanding may be considered large or small stock dividends, depending on the surrounding circumstances.

A **stock split** occurs when the entity issues additional shares to stockholders by decreasing the par or stated value per share and issuing a proportionate number of shares. A stock split does not generally require a journal entry as the amount reported in the common stock account will remain the same. A notation will be made for disclosure purposes, however, as the number of shares will increase and the par or stated value per share will decrease.

Note: All dividends reduce Stockholders' Equity except for stock dividends and stock splits.

Cash Dividend	Scrip—Give dividend but no money	Stock Dividend
RE 25 Cash 25	RE 25 Note payable 25	Small < 20–25% – FMV RE 25 CS 20 APIC 5
	Partial Liquidating Dividend RE 15 APIC 10 Cash 25	Large > 20–25% – Par RE 20 CS 20
Property (FMV) RE **25** Asset 20 Gain **5**	Person receiving Liq Div Cash 25 Div income 15 Investment 10	Stock Splits: Double shares, half par CS (10(10)) 100 CS (20(5)) 100

Net effect on Stockholders' Equity = 20

Revenue & Expenses

Revenue and expense transactions make up the core of the operations of many entities and, in many cases, the auditor will obtain the majority of evidence regarding revenues and expenses through the testing of controls applied to the operating systems. The auditor will first determine if there is reason to believe that revenues or expenses are materially misstated by applying analytical procedures. The auditor may compare recorded amounts to expectations developed independently by the auditor, to budgets prepared by the entity, or by comparison to prior periods.

Evidence supporting amounts reported as revenues and expenses is also obtained through the audit of other areas. The audit of A/R provides evidence regarding revenues, and the audit of current liabilities provides evidence regarding many expenses. In addition, expenses like depreciation and amortization are generally audited at the same time as the related assets are examined.

A large portion of the amount reported as expenses results from cash disbursements made on a routine basis in the ordinary course of business. In performing tests of cash disbursements, including tests of controls, the auditor will generally verify that disbursements for expenses are properly reported. In addition, expenses may be put into *three broad categories*, each of which may be examined differently.

- Some expenses, such as depreciation and amortization, are determined on the basis of applying a formula. The auditor will often rely most heavily on *recalculation* or similar procedures to obtain satisfaction that they are not materially misstated.
- Some expenses, such as rent, interest expense, utilities, and other expenses incurred on a routine basis are subject to a high degree of predictability enabling the auditor to develop expectations as to the amounts that should be reported. Payroll-related expenses also often fall into this category. For those expenses for which expectations can be developed that are adequately precise and adequately reliable, the auditor will rely most heavily on *analytical procedures*.

- Many of the remaining expenses are incurred as circumstances create needs and are not subject to developing meaningful expectations. These expenses may be subjected to various substantive procedures, including *tracing items* to underlying supporting documentation, as considered appropriate by the auditor.

Auditors will often rely more heavily on internal controls when obtaining evidence about revenues and expenses than when auditing B/S accounts. The auditor will determine, based on the required understanding, if the systems are designed to record revenues and expenses in appropriate amounts that are fairly presented.

If the auditor concludes that the systems are potentially effective, the auditor will perform tests of controls to make certain that the systems were in place and operating effectively during the period under audit. Satisfactory results to the tests of controls will allow the auditor to limit the nature, timing, and extent of further audit procedures applied to revenue and expenses.

Many revenue and expense (I/S) accounts are verified when tests of controls are performed over the various functions, such as cash receipts and disbursements, purchases, and sales. In addition, they are verified in conjunction with the audit of related asset or liability (B/S) accounts.

B/S Account	I/S Account
Accounts receivable	Sales, credit loss expense
Inventories & A/P	Purchases, cost of goods sold, manufacturing payroll
Investments	Interest, dividends, gains & losses on sales
Property, Plant & Equipment	Rent, gains & losses on sales, depreciation, epairs & maintenance expense
Notes Receivable	Interest
Accrued liabilities & prepaid expenses	Warranty expense, commissions, fees insurance expense, & various expenses

Revenues and expenses are *I/S accounts* and, as a result, the assertions related to **classes of transactions (CPA-CO)** apply.

- ***Completeness*** – All transactions giving rise to revenues or expenses that relate to the entity

are recognized. A misrepresentation in relation to completeness might include capitalizing costs that should be recognized as expenses or neglecting to record a sale with the proceeds being misappropriated.

- ***P*eriod Cutoff** – All revenues and expenses are reported in the appropriate period. A misrepresentation in relation to cutoff may include recognizing a sale while goods shipped under a destination contract and are still in transit or neglecting to accrue an expense that had been incurred as of the end of the year but had not yet been paid for.
- ***A*ccuracy** (Amounts) – All revenues and expenses have been reported in appropriate amounts. A misrepresentation in relation to accuracy may involve a revenue transaction being reported at an amount lower than the actual sale, or an expense being reported at a higher amount, with the difference being misappropriated.

- ***C*lassification** – All revenues and expenses are appropriately categorized on the F/S. A misrepresentation in relation to classification may involve reporting the proceeds from the sale of an operating asset, such as a machine used in the manufacturing process, as revenues rather than reporting the difference between the proceeds and the carrying value as a gain or loss on sale.
- ***O*ccurrence** – The transaction giving rise to the recorded revenue or expense did occur and pertains to the entity. A misrepresentation in relation to occurrence might result from recording a sale that no customer has approved or recognizing an expense that was incurred on behalf of a member of management but paid for by the entity.

There are various *forms of evidence* the auditor may use in the audit of revenues and expenses. Some will be obtained from the client, some directly from outside sources, and some may result from the direct actions of the auditor. Evidence the auditor may use includes:

- Copies of POs received from customers, sales orders, vendor invoices, requisitions, receiving reports, and various other documents supporting specific transactions.
- Leases, service agreements, and other contracts related to the incurring of regular expenses.
- Spreadsheets and schedules calculating deprecation or amortization expense, interest expense, or other items requiring allocation or otherwise requiring analysis for proper reporting.
- Approvals from management or those charged with governance, as appropriate, for unusual and nonrecurring expenses.
- Budgets and other analyses providing management's expectations as to revenues expected to be earned during the period and expenses expected to be incurred.

CPA-CO Approach to Audit Procedures for Revenues & Expenses

*C*ompleteness

In seeking evidence that all revenue and expense transactions that occurred and pertained to the entity were recorded, the auditor will determine if there are appropriate **controls** in place, such as:

- The use of prenumbered sales invoices and the accounting for all numbers within a sequence
- Comparisons of expenses to budgeted amounts are made on a regular basis with any variances investigated on a timely basis

Substantive procedures may include:

- Comparing recorded revenues and various expenses to the auditor's expectations **(analytical procedures)**
- Tracing a sample of receiving reports and trace them to related transactions recognizing revenue **(inspection)**
- **Recalculation** – The auditor may analyze documents related to purchases of fixed assets to determine if costs that should have been recognized as an expense in the period were capitalized to the cost of the asset.

*P*eriod Cutoff

In seeking evidence that all revenue and expense transactions are recorded in the appropriate periods, the auditor will determine if there are **controls** in place, such as:

- Policies requiring that expenses be compared to budgeted amounts with variances investigated
- Policies requiring that invoices received during a reasonable time after the end of the period be evaluated to determine if they should be included in the period-end accrual

Substantive procedures may include:

- Comparing the relationship between accrued expenses and the entity's monthly payments for expenses to the auditor's expectations to make certain that expenses incurred near the end of the year are reported **(analytical procedures)**
- Tracing payments made during a reasonable time after the end of the period to supporting documents to identify those that were for goods or services received during the period and verify that those amounts are recognized as expenses in the appropriate period **(inspection)**
- Comparing the amount accrued for payroll and payroll-related expenses (eg, payroll taxes) to the auditor's expectation **(analytical procedures**)
- **Inspecting** leases and other arrangements (eg, service agreements) calling for regular payments to determine if all amounts related to the current period have been accounted for

*A*ccuracy (Amounts)

In seeking evidence that all revenue and expense transactions are recorded in appropriate amounts, the auditor will determine if there are appropriate **controls** in place, such as:

- Policies requiring that expenses be compared to budgeted amounts with variances investigated
- Timely reconciliation of statements received from vendors to amounts reported as expenses

Substantive procedures may include:

- Comparing recorded revenues and expenses to the auditor's expectations **(analytical procedures)**
- Tracing a sample of amounts recorded as expenses to supporting documentation to determine if expenses were recorded in correct amounts **(inspection)**
- Tracing a sample of recorded sales transactions to supporting documentation to verify that they were recorded in correct amounts **(inspection)**
- Comparing amounts recorded for interest to estimates computed on the basis of average debt and the entity's borrowing rate **(analytical procedures)**
- Comparing payroll and payroll-related expenses (eg, payroll taxes) to auditor estimates based on the auditor's understanding of the number of employees retained by the entity and pay rates **(analytical procedures)**
- **Inspecting** leases and other arrangements (eg, service agreements) calling for regular payments to determine if amounts are appropriate

- Comparing the amounts reported as expenses in the current period to amounts reported in prior periods **(analytical procedures)**

*C*lassification

In seeking evidence that all revenue and expense transactions are classified into appropriate categories, the auditor will determine if there are appropriate **controls** in place, such as:

- Maintenance of a list of regular vendors, such as utility companies, indicating the category that should be used to classify payments made to them
- A review of the coding of disbursements by the individual signing checks and cancelling the voucher package
- Policies requiring that all transactions recorded as revenues be supported by a customer PO, an appropriate prenumbered sales order form, a sales invoice, and a shipping report

Substantive procedures may include:

- Tracing a sample of transactions recorded as sales to supporting documentation to verify that they represent sales of goods or services in the ordinary course of business **(inspection)**

- Tracing a sample of transactions recorded in various expense categories to supporting documentation to verify that the expense category in which they were recorded is appropriate **(inspection)**

*O*ccurrence

In seeking evidence that revenue and expense transactions actually occurred, the auditor will determine if there are appropriate **controls** in place, such as:

- Policies requiring that all regular expenses, such as rents, utilities, and various other expenses be compared to budget as part of the recording process with variances investigated on a timely basis
- Policies requiring matching documentation including customer POs, sales orders, shipping documents, and sales invoices for all revenue-related transactions before the recording of revenues
- Policies requiring appropriate approvals for all unscheduled expenses
- Policies requiring comparisons of payees, including vendors and employees, to approved vendor lists and lists of active employees maintained by human resources

Substantive procedures may include:

- Tracing a sample of recorded revenue transactions to supporting documentation, including a customer PO, a sales order, a shipping report, and an invoice **(inspection)**
- Tracing a sample of recorded expense transactions to supporting documentation, which may include receiving reports, authorized requests, and vendor invoices **(inspection)**
- **Inspecting** leases to determine if recorded rents are for the use of assets being used by the entity

Payroll

When auditing payroll, the auditor is often able to place reliance on the I/C structure of the payroll cycle and assess RMM at a low level, thereby permitting higher detection risk and limiting the necessary substantive testing. Since payroll is generally more predictable than other costs, the auditor should perform **analytical procedures** involving the comparison of actual payroll costs with budgeted or standard costs to determine **completeness** of payroll accruals.

To support the assertion of **valuation**, the auditor should recalculate payroll accruals and compare calculations with source information, such as timecards to verify hours worked and personnel records to verify pay rates.

Objectives

- I/C over payroll
- Employees actually exist (existence).
- Payroll computations are correct (valuation).
- Disclosure is adequate.